ANDREW G. HUTCHISON

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LLM RESEARCH PAPER

LAW AND MARKETS (LAWS 536)

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ABSTRACT

This paper assesses the validity of the justifications for the mandatory disclosure regime imposed on issuers of securities to the public in New Zealand. In Part I, there is a description of the statutory requirements comprising this regime. In Part II, firstly, the justifications for the mandatory disclosure requirements imposed under the Companies Act 1993 are considered. These justifications are distinguished from the ones imposed on issuers of securities by the SA 1978 and the New Zealand Stock Exchange listing rules. Secondly, the likely level of security disclosure under a voluntary disclosure regime is set out. Thirdly, there is a discussion of the justifications for the mandatory disclosure regime in the Securities Act 1978 and the New Zealand Stock Exchange listing rules. The primary justifications are arranged in two categories these are efficiency justifications and fairness justifications. This section considers the effect of market forces, the effect of the action of the share market, the impact of the Companies Act 1993 disclosure requirements, and relevance of other options (beside mandatory disclosure) for solving the problems discussed. In Part III, the paper concludes that there is little justifiable reason for a mandatory disclosure regime but that New Zealand needs to retain its regime to maintain international confidence it its share-market.

The text of this paper (excluding footnotes and annexures) comprises approximately 12,000 words.

INTRODUCTION

This paper examines the reasons for requiring issuers of securities to the public in New Zealand to disclose information.

In Part I, four levels of regulation are outlined. Firstly, general misrepresentation law which prohibits misrepresentations in trade and misrepresentations that induce entry into a contract. Secondly, the Companies Act 1993 which imposes disclosure requirements on companies. Thirdly, the Securities Act 1978 and the Financial Reporting Act 1993 which impose disclosure requirements on issuers of securities to the public. Finally, the New Zealand Stock Exchange (NZSE) listing rules, which impose additional disclosure requirements on issuers, listed on the NZSE.

In Part II, the justifications for mandatory disclosure are set out. I will not question the necessity of the first two levels of regulation (misrepresentation law and company law) but I will examine the justifications for the second two levels (the Securities Act 1978 and the NZSE listing rules). The latter two levels of regulation form the 'mandatory disclosure regime' imposed on issuers of securities.

Part III provides a conclusion concerning whether this mandatory disclosure regime is justified.

PART I THE NEW ZEALAND REGULATORY REGIME

I THE LAW OF MISREPRESENTATION

A The Fair Trading Act 1986

Section 9 of the Fair Trading Act [FTA 1986] deals with pre-contractual misrepresentations. This section says, "No person shall, in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive." Sections 10 and 11 of the FTA 1986 prohibit misleading conduct in trade in relation to goods and services. Section 13 of the FTA 1986 concerns false representations connected with the supply or promotion of goods or services. Falsely representing that goods or services are of a particular quality, have any performance characteristics, are endorsed, or have a guarantee or warranty is prohibited.

Conduct caught under section 9 includes omissions.[1] Silence is forbidden if it is misleading or deceptive. This would generally need "some conduct that is ancillary to the silence, and when construed with the silence creates the misrepresentation."[2] Thus, a promoter of securities could be caught under the FTA 1986 for any disclosure or non-disclosure that is a misrepresentation, and for making certain false representations connected with the supply of the securities.

There are extensive penalties for a breach of the FTA 1986. These include; an injunction restraining a person from engaging in conduct that would breach the Act,[3] variation or avoidance of a contract between the person who engaged in the conduct and the person who suffered damage or is likely to suffer damage (or, if the Court thinks fit, an order that the contract is to have been void *ab initio*),[4] and an order that

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[1] Fair Trading Act 1986, s 2(2)(a) [FTA 1986].
[2] Raynor Asher, "The Vile Intrusion / Magnificent Intervention of the Fair Trading Act into Contracts" [1996] NZLJ 85, 86.
[3] FTA 1986, s 41(1).
[4] FTA 1986, s 43(2)(a) and (b).

person who engaged in the conduct refund or pay damages to the person who suffered the loss or damage.[5]

B The Common Law

In common law, misrepresentation is an area of the law of contract. It has been defined as where "one party is induced to enter into [a] contract by the false assertion of the other."[6] Misrepresentations can be intentional or unintentional. For a misrepresentation to occur there needs to be a representation that induces entry into a contract resulting in loss to the representee.[7]

The "general rule is that silence cannot constitute misrepresentation."[8] However there are a number of exceptions to this.

In the English case of *R v Kylsant*[9] the Court of Criminal Appeal dealt with statements in a prospectus relating to the issue of debenture stock. Although the statements were all true they were "utterly misleading"[10] and the prospectus was held to be false. The statements were rendered "essentially untrue"[11] by silence that created a false impression. Thus silence may constitute a misrepresentation. In the New Zealand case of *King v Wilkinson*[12] Holland J noted that "[i]n certain limited circumstances misrepresentation can arise from silence."[13] Holland J held that whether a misrepresentation has been made is a question of fact. In *King v Wilkinson* it was decided that there was a misrepresentation when a vendor of a property did not alert the purchaser that the fence was not on the true boundary of the property.

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[5] FTA 1986, s 43(2)(c) and (d).
[6] R D Mulholland, *Introduction to the New Zealand Legal System* (9 ed, Butterworths, Wellington, 1999) 257.
[7] Mulholland, above n 6, 259.
[8] Francis Dawson and David W. McLauchlan *The Contractual Remedies Act 1979* (Sweet & Maxwell, Auckland, 1981) 20.
[9] [1932] 1 KB 442.
[10] R v Kylsant, above n 10, 449.
[11] Mulholland, above n 6, 258.
[12] Unreported, High Court, Christchurch CP 134/92, 29 March 1994.
[13] *King v Wilkinson* above n 12.

'Contracts *uberrimae fidei*' are contracts where "one party alone possesses full knowledge of all the material facts."[14] In these contracts the common law requires the knowledgeable party to disclose all material facts. This rule usually applies in insurance contracts but may also be relevant to contracts for the sale of securities.

Where there is a fiduciary relationship between the parties to a contract "silence could amount to a misrepresentation"[15] Fiduciary relationships arise where there is a relationship of trust between the parties, for instance a solicitor and client. It is possible that because of the asymmetry of information between the vendor of securities and the subscriber a fiduciary relationship might arise.[16] In this situation silence may be a misrepresentation. Therefore in some situations the issuer would be obliged to disclose information.

The above discussion shows that there is sometimes an obligation to disclose information imposed on parties to a contract. There is also liability for a disclosure of information that constitutes a misrepresentation.

C The Contractual Remedies Act 1979

The remedies for misrepresentation are contained in the Contractual Remedies Act 1979 [CRA 1979]. Section 6 of the CRA 1979 entitles a party to a contract to claim damages from the other party for a misrepresentation, inducing them to enter into the contract, made by that party. Section 7(3)(a) of this Act allows a party to a contract to cancel the contract if they have been induced to enter into it by a misrepresentation made by the other party to the contract. These sections apply regardless of whether the misrepresentation is innocent or fraudulent. These remedies are less extensive than those under the FTA 1986 are.

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[14] J F Northey, *Cheshire and Fifoot's Law of Contract* (6 ed, Butterworths, Wellington, 1984) 234.
[15] R D Mulholland *Business Law Today* (4 ed, The Dunmore Press, Palmerston North, 1995) 161.
[16] In *Coleman and Others v Myers and Others* [1977] 2 NZLR 298 (CA) the New Zealand Court of Appeal held that the directors of a company owed fiduciary duties to the shareholders. These duties arose, among other reasons, because of the level of inside knowledge possessed by the directors. Because of the fiduciary duties that existed the directors were obliged to not make misleading statements and to disclose material maters as to which they knew the shareholders were inadequately informed. Based on this case it is likely that a fiduciary relationship would arise between a promoter of securities and the subscriber because of the information asymmetry between the parties.

In *Cox & Coxon Ltd v Leipst*[17] the New Zealand Court of Appeal held that section 9 of the FTA only prohibits certain conduct, it does not "render representations binding."[18] However section 6 of the CRA 1979 does make representations binding if they induce entry into a contract. It entitles the representee to damages "as if the representation were a term of the contract."[19] The Court in *Coxon* held that a misrepresentation inducing entry into a contract cannot "give rise to a claim for expectation losses"[20] under the FTA 1986. Thus, the broad provisions of the FTA 1986 do not completely override the need for the CRA 1979.

The law concerning misrepresentation discussed in this section has the effect of providing a penalty for fraudulent disclosure and for non-disclosure that amounts to a misrepresentation. The relevance of this to New Zealand's mandatory disclosure regime will be discussed in Part II, II A 2 (a) of this paper.

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[17] [1999] 2 NZLR 15 (CA).
[18] *Cox & Coxon Ltd v Leipst* above n 17, 22 per Gault J.
[19] Contractual Remedies Act 1979, s 6(1)(a).

II THE COMPANIES ACT 1993

A Financial Information

1 Accounting records

Section 194 of the Companies Act 1993 (CA 1993) imposes a duty on companies to keep accounting records. These records must comply with the Financial Reporting Act 1993.[21] It is the board of directors' responsibility to keep accounting records.[22] If the board fails to comply with this requirement the every director[23] commits an offence is liable on conviction to a fine not exceeding $10,000.[24]

2 The annual report

Section 208 of the CA 1993 requires the board of every company to prepare an annual report. Under section 209 this report has to be sent to the shareholders "not less that 20 working days before the … annual meeting of shareholders." Under section 211 the annual report must contain the financial statements prepared "in accordance with section 10 of the Financial Reporting Act 1993"[25] and the auditor's report on those statements.[26] These financial statements are discussed in Part I, III E of this paper. The annual report must also include the interests register entries,[27] remuneration received by the directors,[28] and other items.[29] If the annual report is not sent to the shareholders every director of the company commits an offence and is liable on conviction to a fine not exceeding $10,000.[30]

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[20] *Cox & Coxon Ltd v Leipst* above n 17, 26 per Henry J.
[21] Companies Act 1993, s 194(1)(c) [CA 1993]. The Financial Reporting Act 1993 is discussed in Part I, III E of this paper in the section dealing with disclosure under the Securities Act 1978.
[22] CA 1993, s 194(1).
[23] CA 1993, s 126 defines a director as "any person occupying the position of a director of the company by what ever name called." The focus is on the duties and powers of the person and the definition is not limited to persons on the board of directors.
[24] CA 1993, s 194(4).
[25] CA 1993, s 211(1)(b).
[26] CA 1993, s 211(1)(c).
[27] CA 1993, s 211(1)(e). This is discussed in Part I, II B of this paper.
[28] CA 1993 211(1)(f).
[29] Other items to be included in the annual report include a description of changes in accounting policies, changes in the nature of the business, donations made by the business, and the number of employees who received $100,000 or more remuneration (CA 1993, s 211(a),(d),(g), and (h)).
[30] CA 1993, s 208(2).

B The Interests Register

A company must keep an interests register at its registered office.[31] This is a "list of material interests which the directors have in businesses with which the company is dealing or transactions involving the company."[32] The information to be included in the interests register includes; a director's interest[33] in transactions of the company,[34] information acquired in his or her capacity as a director which is to be used other than for the purpose of the company or that is to be disclosed to any person,[35] information concerning a director's acquisition or disposition of shares issued by the company,[36] and any remuneration received by a director.[37]

C The Annual Return

Under section 214 of the CA 1993 the board must ensure an annual return is delivered to the Registrar of Companies each year for registration.[38] The annual return must contain information specified on the Forth Schedule to the CA 1993. This information includes the address of the company, details of where records are kept, information relating to the shares and the shareholders of the company, and the names and addresses of the directors of the company.[39] If the board fails to comply with this requirement every director commits an offence and is liable on conviction to a fine not exceeding $10,000.[40]

D Inspection of a Company's Records

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[31] CA 1993, s 189(1)(c).
[32] Andrew Beck and Andrew Borrowdale, *Guidebook to New Zealand Companies and Securities Law* (5 ed, CCH New Zealand Limited, Auckland, 1994) 208.
[33] CA 1993, s 139 defines when a director is 'interested' in a transaction, it includes situations where the director is a party to the transaction, will derive a material financial benefit from the transaction, or has a material financial interest in another party to the transaction.
[34] CA 1993, s 140(1).
[35] CA 1993, s 145(3)(a).
[36] CA 1993, s 148(1)(b).
[37] CA 1993, s 161(2).
[38] CA 1993, s 214(1).
[39] The Forth Schedule to the CA 1993.
[40] CA 1993, s 214(10).

A company must keep records available for inspection by the public for inspection by its shareholders. The information available to the public is general information about the company including the share register and the company constitution.[41] The information available the shareholders includes the interests register, minutes of all meetings and resolutions of shareholders, and information given to all of the shareholders during the previous 10 years.[42] If the company fails to comply with these two requirements every director commits an offence and is liable on conviction to a fine not exceeding $10,000[43] and the company commits an offence and is liable on conviction to a fine not exceeding $10,000.[44]

E Disclosure of a Company's Records

1 Section 178 of the Companies Act 1993

Section 178(1) states that "[a] shareholder may … make a written request to a company for information held by that company." The company must either provide the information, agree to provide the information within a specified period, or refuse to provide the information, within 10 working days of receiving the request.[45] The company must specify the reasons for a refusal to provide information.[46] Reasons for which a company may refuse to supply information include that "[t]he disclosure of the information would or would be likely to prejudice the commercial position of the company"[47] or of "any other person"[48] or that "the request … is frivolous or vexatious."[49] If the High Court is satisfied that the company "did not have sufficient reason to refuse to supply the information," or that "other reasons exists that outweigh the refusal," it may "make an order requiring the company to supply the information."[50]

[41] CA 1993, s 215.
[42] CA 1993, s 216.
[43] CA 1993, ss 215(2)(b) and 216(2)(b).
[44] CA 1993, ss 215(2)(a) and 216(2)(a).
[45] CA 1993, s 178(3).
[46] CA 1993, s 178(3)(d).
[47] CA 1993, s 178(4)(a).
[48] CA 1993, s 178(4)(b).
[49] CA 1993, s 178(4)(c).
[50] CA 1993, s 178(7).

2 *Section 179 of the Companies Act 1993*

Under section 179(1) of the CA 1993 a shareholder or a creditor of a company can apply to the High Court for a person to inspect a company's records. The Court may authorise the person to inspect the company's records if the inspection is for a proper purpose and the shareholder or creditor is acting in good faith. Under section 179(4), on receiving the report of the inspector, the Court can make an order in relation to disclosure of records and information, as it thinks fit.

F Dealing with Shares

1 *Repurchase of shares*

There are disclosure requirements relating to a company buying back its own shares. These requirements are different for different types of share buy-back.

For a proportional buy-back[51] the board has to resolve that "it is not aware of any information that will not be disclosed to shareholders- (i) [w]hich is material to an assessment of the value of the shares; and (ii) [a]s a result of which the terms of the offer and the consideration offered for the shares are unfair to shareholders accepting the offer."[52] Thus, often the board will not be able to carry out this type of buy-back unless disclosure is made to the shareholders.

For a selective buy-back[53] the company must send a disclosure document to all the shareholders.[54] This document must include the nature and terms of the offer; the relevant interest of any directors in any of the shares, the text of a resolution that the acquisition is of benefit to all the remaining shareholders and that the terms of the offer are fair and reasonable to them, and any further information necessary to enable

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[51] CA 1993, s 60(1)(a). This is when a company makes an offer to all shareholders to acquire a portion of their shares. The offer must not affect relative voting and distribution rights (this means the shareholders must be entitled to participate rateably).
[52] CA 1993, s 60(3)(c).
[53] CA 1993, s 60(1)(b). This is when a company makes an offer to acquire the shares of one or more shareholders with the consent of all the other shareholders.
[54] CA 1993, s 60(5).

a shareholder to understand the implications of the acquisition for the company and the shareholders.[55]

For a stock exchange acquisition[56] a disclosure document must be sent to all shareholders.[57] This document[58] is similar to the one required for selective buy-backs. Under section 65 information may be disclosed subsequent[59] to a stock exchange acquisition if the number of shares acquired does not exceed 5% of the shares of the same class.[60]

2 *Redemption of shares*

Share redemption is different from a repurchase of shares because it does not require the consent of both the company and the shareholder involved. The company or the shareholder can exercise share redemption unilaterally.[61] For a share to be redeemable by the company the constitution of the company has to make provision for the redemption in one of three ways. These are "at the option of the company," "at the option of the holder of the share," or "on a date specified in the constitution."[62] The consideration to be paid for the shares must be either specified, calculated by reference to a formula, or required to be fixed by a person not associated with the interests of the company.[63]

There are three ways a company can exercise its option to redeem shares. Firstly, the option can be exercised "in relation to all shareholders of the same class and in a manner that will leave unaffected relative voting and distribution rights."[64] Secondly, the option can be exercised "in relation to one or more shareholders and ... [a]ll shareholders have consented in writing."[65] Thirdly, the option can be exercised "in

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[55] CA 1993, s 62.
[56] CA 1993, s 63. This is an offer made through the stock exchange to all shareholders to acquire a specified number of shares.
[57] CA 1993, s 63(6).
[58] CA 1993, s 64.
[59] Within 10 working days after the share are acquired (CA 1993, s 65(2)).
[60] CA 1993, s 65(1)(b).
[61] Beck and Borrowdale, above n 32, 102.
[62] CA 1993, s 68(a),(b), and (c).
[63] CA 1993, s 68(d),(e), and (f).
[64] CA 1993, s 69(1)(a).
[65] CA 1993, s 69(1)(b)(i).

relation to one or more shareholders and … the option is expressly permitted by the constitution."[66]

For the exercise of the option under the third way a disclosure document must be sent to each shareholder.[67] This document must set out the nature and terms of the redemption and the names of the shareholders that the option is to be exercised in relation to, the text of a board resolution that the redemption is of benefit to the remaining shareholders, that the consideration for the redemption is fair and reasonable to them, and the grounds for these conclusions, and any further information and explanation necessary to enable a shareholder to understand the implications of the redemption for the company and its shareholders.[68]

3 *Financial assistance*

Section 76 of the CA 1993 allows a company to "give financial assistance to a person for the purpose of … the purchase of a share issued or to be issued by the company." There are three options for giving financial assistance.

Firstly, all shareholders can consent to the giving of the assistance.[69] In order for the shareholders to consent, the particulars of the assistance would have to be disclosed to them.

Secondly, the company may give assistance complying with section 78.[70] Under section 78(5) a disclosure document complying with section 79 must be sent to each of the shareholders. This document must set out the nature and terms of the financial assistance, the text of a resolution that the assistance is for the benefit of the shareholders not receiving the assistance and that the terms and conditions of the assistance are fair and reasonable to those shareholders, and such further information and explanation necessary to enable a shareholder to understand the implications of the assistance for the company and the shareholders.[71]

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[66] CA 1993, s 69(1)(b)(ii).
[67] CA 1993, s 71(1)(5).
[68] CA 1993, s 72.
[69] CA 1993, s 76(1)(a).
[70] CA 1993, s 76(1)(b).
[71] CA 1993, s 79.

Thirdly, the company may give assistance in accordance with section 80.[72] Financial assistance under section 80 can only be given if the amount of the assistance would not exceed 5 percent of shareholders' funds.[73] Under section 80(1)(b) a disclosure document has to be sent to each of the shareholders. This document must set out the class and the number of shares in respect of which the financial assistance has been given, the consideration paid for those shares, the identity of the person receiving the assistance, and the amount of financial assistance.[74]

G The Registrar's Powers of Inspection

Under section 365 of the CA 1993 the Registrar of Companies (or a person authorised by the Registrar) may, if in their option it is in the public interest to do so, require a banker to produce for inspection relevant documents,[75] "inspect and take control of relevant documents",[76] or take possession of or retain relevant documents,[77] for the purpose of ascertaining whether a company or director is complying with, detecting offences against, and ascertaining whether the Registrar should exercise any of his or her powers under the CA 1993 or the FRA 1993.[78]

Section 366 of the CA 1993 allows for disclosure of information and reports. A person who has obtained a document or information in the course of an inspection under section 365 or prepared a report in relation to an inspection under section 365 must give the document or information to certain persons if directed to do so by the Registrar.[79] The persons the information can be given to include the Minister of Justice, the Secretary for Justice, a person authorised by the Registrar to receive the information for the purposes of or in connection with the exercise of powers under the CA 1993 or detecting offences under the CA 1993, and a liquidator.[80] A person who

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[72] CA 1993, s 76(1)(c).
[73] CA 1993, s 80(1)(a).
[74] CA 1993, s 80(1)(b).
[75] CA 1993, s 365(1)(c).
[76] CA 1993, s 365(1)(d).
[77] CA 1993, s 365(1)(e) and (f).
[78] CA 1993, s 365(1)(a)(i),(ii), and (iii).
[79] CA 1993, s 366(1)(a) and (b).
[80] CA 1993, s 366(1)(c),(d),(e),(f), and (g).

fails to comply with section 366 commits an offence and is liable on conviction to a fine not exceeding $10,000.[81]

H Privileged Communications

Section 393 of the CA 1993 says, "nothing in the Act requires a legal practitioner to disclose a privileged communication."[82] This does not apply to the liquidator's power to require information from a solicitor.[83] The High Court "may, on application of any person, determine whether or not a claim of privilege is valid."[84]

[81] CA 1993, s 366(4).
[82] CA 1993, s 393(1).
[83] CA 1993, s 393(2).

III THE SECURITIES ACT 1978

A The Scope of the Securities Act 1978

The Securities Act 1978 [SA 1978] concerns the offering of securities to the public.[85] A security is defined as "any interest or right to participate in any capital, assets, earnings, royalties, or other property of any person."[86] This definition covers shares, bonds, debentures, and all other types of security.

B Section 33

Section 33 in Part II of the SA 1978 states: "No security shall be offered to the public for subscription, by or on behalf of an issuer, unless - (a) [t]he offer is made in, or accompanied by, an authorised advertisement that is an investment statement that complies with this Act or regulations; or (b) [t]he offer is made in an authorised advertisement that is not an investment statement; or (c) [t]he offer is made in, or accompanied by, a registered prospectus that complies with this Act and regulations."[87] The issuer is "the person on whose behalf any money paid in consideration of the allotment of the securities received."[88] This is the company issuing the securities to the public. Section 3(2) of the SA 1978 concerns when an offer is not to the public. This includes an offer of securities to relatives or business associates of the issuer and persons whose business is the investment of money. Therefore 'public' is intended to cover people who do not have relevant information about the issuer or the means to get that information. There are some specific exemptions from Part II of this Act set out in section 5 of the SA 1978.[89]

C The Investment Statement

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[84] CA 1993, s 393(5).
[85] The long title of the Securities Act 1978 (SA 1978) say it is "[a]n Act to establish a Securities Commission; and to consolidate and amend the law relating to the offering of securities to the public, and to extend the application thereof."
[86] SA 1978, s 2D.
[87] SA 1978, s (1)(c).
[88] SA 1978, s 2(1).
[89] These include an exemption for registered banks, mortgages of land and estates or interest in land.

A prospective investor must receive an investment statement before subscribing for a security.[90] The investment statement is the primary disclosure document required for an issue of securities to the public. Its purpose is to "[p]rovide certain key information that is likely to assist a prudent but non-expert person to decide whether or not to subscribe for securities."[91] The investment statement contains information about the securities being issued and the issuer.[92] This information must not be false or misleading.[93] The investment statement must answer a number of questions these include:[94]

What sort of investment is this?

How much do I pay?

What returns will I get?

What are the risks?

D The Prospectus

The prospectus is "a document that contains an offer of securities to the public for subscription, and that is intended to be, or has been, delivered to the Registrar for registration."[95] The prospectus is a more detailed disclosure document than the investment statement. It was the primary disclosure document before October 1997. The prospectus does not have to be provided to an investor unless it is requested. The

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[90] SA 1978, s 37A(1)(a) if this section is breached the allotment of securities is "voidable at the instance of the subscriber"(SA 1978, s 37A(3)).

[91] SA 1978, s 38D(a), the requirement for an investment statement was included in this Act after 1993 Parliamentary Accord on Retirement Income Policies (set up based on recommendations from the Todd Taskforce on Private Provision for Retirement (1991)) recommended new regulations for investment product disclosure. Two suggestion of the Periodic Report Group of the Accord were that "consumers should have access to unbiased information about the savings products they are considering" and that "the information should be clear, comprehensive, and designed to enable prudent but non-expert savers to make meaningful comparisons between similar savings products." (Interim Report of the Periodic Report Group, July 1997, 70.) This led to changes in the disclosure requirements, in the SA 1978, which came into effect on the 1st of October 1997. These changes are designed to encourage people invest in the security market to save for their retirement.

[92] The requirements for an investment statement are contained in the Securities Regulation 1983 Schedule 3D. See Appendix A for a list of the matter required to be disclosed.

[93] SA 1978, s 37A(b). If the information is false or misleading Section 37A(3) applies (see note 90). Section 38F gives the New Zealand Securities Commission [NZSC] the power to suspend or prohibit the distribution of an investment statement if it is "likely to deceive, mislead, or confuse" (SA 1978, s 38 F(1)(a)).

[94] Securities Regulations 1983 Schedule 3D, Regulation 1(1).

[95] SA 1978, s 2(1).

investment statement must state that a copy of the prospectus is available on request.[96] If a prospective investor asks for a prospectus the issuer is obliged to send them one within 5 working days.[97] The requirements for a prospectus are set out in section 39 of the SA 1978 and in the schedules of the Securities Regulations 1983.[98] Section 41 of the SA 1978 requires registration of the prospectus by delivering it to the Registrar of Companies.[99] If the prospectus does not comply with the SA 1978 or contains faults the Registrar may refuse to register it.[100] If a statement in the prospectus is untrue[101] the directors who signed the prospectus are liable to pay compensation to all people who subscribed to the securities.[102] Distributing a prospectus with an untrue statement is also a criminal offence.[103]

E Financial Statements

A The Financial Reporting Act 1993

The purpose of the Financial Reporting Act 1993 [FRA 1993] is to "[r]equire issuers of securities to the public to file financial statements that comply with generally accepted accounting practice and give a true and fair view of their affairs."[104] To achieve this the FRA 1993 established the Accounting Standards Review Board[105] [ASRB]. The function of the ASRB is to review financial reporting standards.[106]

Section 10 of the FRA 1993 creates an obligation on the directors of every "reporting entity" to prepare financial statements. A reporting entity includes an "issuer."[107] The definition of 'issuer' in section 4 of the FRA 1993 includes companies that have offered securities to the public in accordance with the SA 1978.

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[96] Securities Regulations 1983 Schedule 3D Regulation 23A(e).
[97] SA 1978, s 54B(2). If the issuer fails send the prospectus there could be a fine of up to $10,000 for the issuer and each of the directors (SA 1978, s 60(2)).
[98] See Appendix B.
[99] For the prospectus to be registered under section 41 it needs to be signed by the directors of the issuer and to contain all the information required under the Securities Regulations 1983.
[100] SA 1978, s 42(2).
[101] This means misleading in its form or by reason of an omission of information (SA 1978, s 55).
[102] SA 1978, s 56.
[103] SA 1978, s 58(5). The penalties may not exceed 5 years in prison or a $25,000 fine.
[104] The long title of the Financial Reporting Act 1993, (a) [FRA 1993].
[105] FRA 1993, s 22.
[106] FRA 1993, s 24.

Section 11(1) of the FRA 1993 states that the financial statements must comply with generally accepted accounting practice; this means financial reporting standards[108] approved by the ASRB.[109] Under section 11(2) of the FRA 1978 if the financial statements "do not give a true and fair view of the matters to which they relate, the directors of the reporting entity must add such information and explanations as will give a true and fair view of those matters." The financial statements also have to be audited[110] and the auditor is required to prepare a report stating whether all of the information and explanations required have been provided, and whether the financial statements give a true and fair view of the company's affairs.[111] The directors of the issuer then have to register the financial statements with the Registrar of Companies.[112] The financial statements are a balance sheet, a profit and loss statement, and a statement of "cash flows."[113] These documents are to be included in the company's annual report.

F Periodic and On Request Disclosures

Section 54A of the SA 1978 requires information to be sent periodically to security holders. The details concerning the information to be provided is to be prescribed by regulation, however as yet there are no regulations dealing with this.

Section 54B requires information to be disclosed to security holders on request. Under section 54B(1) the items listed in regulation 23A of the Securities Regulations 1983 must be disclosed on request. These items include the prospectus, the investment statement, the annual report and financial statements of the issuer, deeds of trust or participation relating to the securities held by the security holder, a copy of any guarantee of payment of money owing in respect of these securities, and financial results relating to prospective financial information about the issuer or about returns on securities that were disclosed by the issuer. Under section 54B(3) if a security holder or a prospective investor requests a copy of the registered prospectus the issuer

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[107] FRA 1993, s 2(1).
[108] FRA 1993, s 3.
[109] FRA 1993, s 27.
[110] FRA 1993, s 15.
[111] FRA 1993, s 16.
[112] FRA 1993, s 18.
[113] FRA 1993, s 8(1)(a), (b), and (c).

must send them one and also any financial statements registered under the FRA 1993 that are referred to in the prospectus and any documents extending the period during which allotments may be made under the registered prospectus.

G The New Zealand Securities Commission

The New Zealand Securities Commission [NZSC] was established by section 9 of the SA 1978. Its function is to review securities law and practice and to "promote public understanding of" securities law and practice.[114] It has power to suspend or cancel a prospectus if the disclosure requirements of the SA 1978 and regulations are not complied with[115] and also power to exempt issuers from having to comply with any of the disclosure provisions of this Act.[116] The NZSC also investigates and publishes reports on suspected breaches of the disclosure provisions by issuers.[117]

[114] SA 1978, s 10(b),(c), and (d).
[115] SA 1978 s 38F(1).
[116] SA 1978, s 5(5).

IV THE NEW ZEALAND STOCK EXCHANGE LISTING RULES

A Listing Contract

To list on the NZSE an issuer must enter into a listing agreement with the NZSE. This is a contract between the NZSE and the issuer and the listing rules of the NZSE are terms in this contract.[118] The listing rules are enforceable against the issuer by the NZSE (the independent Market Surveillance Panel is also responsible for administering and enforcing the rules) or by any security holder of the issuer.[119] Sanctions for a breach of the rules include suspension of the quotation of a security, cancellation of the listing of an issuer,[120] or disclosure of information to all participants of the NZSE.[121]

B Continuous Disclosure Obligation

Section 10 of the listing rules deals with disclosure of information. Rule 10.1.1(c) states every issuer shall "release all Relevant Information to the Exchange immediately [when] it ceases to have greater value to the Issuer ... for the information to remain confidential. It shall not be a sufficient reason to withhold Relevant Information, that release of it may adversely affect the market price of any of the Issuer's Quoted Securities."[122] This is what is known as a continuous disclosure

[117] SA 1978, s 28A gives the NZSC the power to publish reports. There have been reports published on inquiries into prospectus disclosures of at least two issuers (Agricola Resources Limited (in July 1991) and Metropolitan Life Care Limited (in April 1996)).

[118] In the case of *New Zealand Stock Exchange v Listed Companies* (1984) 1 NZLR 699 the Court of Appeal held that the relationship between the New Zealand Stock Exchange [NZSE] and the listed company is contractual not statutory. Thus the NZSE can vary its rules arbitrarily and is not subject to the administrative law remedies of the Judicature Amendment Act 1972. The NZSE also has the power to interpret its listing rules and make rulings regarding the application of the rules.

[119] Listing rule 2.1.1 says the rules are "a contract enforceable against each Issuer for the benefit of every person who is or was a holder of Quoted Securities of that Issuer in the period in which the Issuer is or was listed and the Contracts (Privity) Act 1982 shall apply accordingly." This is referring to section 4 of the Contracts (Privity) Act 1982, which concerns people who are not parties to a contract enforcing a promise made in it. Before an action at law by a security holder is commenced "such a party shall apply to have a determination made by the Exchange"(rule 1.4.3) to determine the meaning of the rules (pursuant to rule 1.4.1).

[120] Listing rule 5.4.2 gives the NZSE power to cancel or suspend a listing, rule 5.4.3(b) provides that an issuer not complying with the rules is a reason for the NZSE exercising its power under 5.4.2.

[121] Listing rule 2.3.2(b) this information is disclosed by the Market Surveillance Panel not the NZSE.

[122] Relevant information is defined in rule 1.1.2 as "at any time information received or generated and held by an Issuer about its undertakings, activities, business environment, prospects, financial position, or financial performance which is not reasonably available to an informed investor ... and which upon

obligation. Information that is to be disclosed has to be sent to the NZSE in accordance with rule 10.2.

Thus, issuers have to disclose to all participants of the NZSE as much relevant information as they can without damaging their own interests. This requirement is based on the objectives of the NZSE. The NZSE states "[t]he main objective of the NZSE is to operate an open and efficient market. A reliable flow of information is vital to the attainment of this goal."[123]

C Information Already Released

Rule 10.1.1(d) states every issuer shall "release Relevant Information to the Exchange no later than it is received by: (i) any person who is not bound by … obligations of confidence … or (ii) any person who is likely to use it in deciding whether or not to deal with Quoted Securities of the Issuer or to divulge it … to any such person."

D Directors' Conflicts of Interest

Rule 10.1.2 requires disclosure of "all arrangements … in respect of which Members of the Public … might reasonably consider the Directors have a conflict of interest which may lead them to approve terms which are materially more favourable to the other parties than arm's length terms." This applies whether or not the information is 'relevant'.[124]

E Annual Reports and Preliminary Announcements

The NZSE rules also regulate the disclosure of annual reports under rule 10.5. These rules require more than just the information required by CA 1993. Rule 10.4.2 requires a preliminary announcement to be released before the annual report. This announcement includes disclosure of major changes or trends in the issuer's business,

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disclosure to the market would, or would be likely to, affect materially the market price of any of the Issuer's Quoted Securities."

[123] Foreword to the listing rules.

the value of the issuer's assets, its profitability, and its contingent liabilities. Rule 10.5.3 requires information about the names and holdings of the equity securities of the 20 largest holders, details about the spread of the security holders, and disclosure of the credit rating of the issuer. Rule 10.5.4 requires disclosure of any director appointed and the security holders who appointed that director.

F A Company Acquiring its Own Securities

A listed issuer must comply with rules 7.6.1 and 7.6.2 if it wants to acquire its own securities. Rule 7.6.1 requires compliance with the CA 1993 provisions concerning this sort of acquisition. Rule 7.6.2 requires that prior notice of the acquisition[125] be given to the NZSE if the acquisition is from a holder who holds more than a minimum holding[126] of the securities of the issuer.

[124] See note 122.

[125] The prior notice needs to specify "a period of time not exceeding 12 months from the date of the notice within which the Issuer will acquire Equity Securities" and "the Class and maximum number of Equity Securities to be acquired in that period" (rule 7.6.2(a) and (b)).

PART II THE JUSTIFICATIONS FOR MANDATORY DISCLOSURE

I THE COMPANIES ACT 1993 DISCLOSURE REQUIREMENTS

Before the CA 1993 was enacted there was a discussion in Parliament concerning the disclosure provisions. Two areas of disclosure were identified and discussed, and "[d]isclosure for the purpose of maintaining efficient and fair markets for the securities issued by companies was separated from disclosure for the purposes of … 'core company law'."[127] The former area of disclosure is covered by the provisions contained in the SA 1987 and the FRA 1993 and the latter area is covered by the provisions in the CA 1993.

The disclosure provisions contained in the CA 1993 are "disclosure of managerial activity as a matter of associational interests"[128] and for the protection of creditors.[129] The general reasons for mandating disclosure for 'core company law' differ from the reasons for mandating disclosure to regulate the security market. However, although the goals may be different, the specific disclosure required is often the same. This results in a duplication of disclosure requirements in these two areas.

Below is a brief outline of the reasons for the CA 1993 disclosure provisions. This paper is not concerned with the validity of these reasons but it seeks to differentiate the reasons for disclosure based on company law from reasons based on regulation the security market. This is so that the justifications for the company law requirements are not used to justify regulation in the security market.

The arguments in this section are not relevant in the context of the regulation of the security industry since any deficiency in achieving these goals can be remedied by strengthening CA 1993, requirements not the disclosure regime in the SA 1978 or the

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[126] A minimum holding of securities is the number of securities set out in appendix 2 of the NZSE listing rules. This number depends on the price of the securities.
[127] David Wishart, *Company Law in Context* (Oxford University Press, Auckland, 1994) 258.
[128] Wishart, above n 127, 258.

listing rules. In this section 'mandatory disclosure' refers to the disclosure requirements in the CA 1993.

A The Shareholders' Monitoring of Management

Disclosure of information may allow shareholders to see whether a director has breached his or her fiduciary duties. Shareholders have incentives to monitor management "in order to reduce the likelihood that the managers will undertake actions that are inefficient or involve misappropriation of company assets."[130] This monitoring would limit dishonest conduct by the directors. Disclosure can also allocate responsibility where it belongs, rather than the whole company being punished for dishonest conduct by one manager. Thus, mandatory disclosure in the context of company law useful for making management accountable for fraud. Disclosure of information is often compared to sunlight, in that it has a disinfectant effect, because its exposes managerial behaviour and increases accountability.[131]

1 Reducing agency problems

Required disclosure can help to "reduce the cost of monitoring promoters' and managers' use of corporate assets for self interested purposes."[132] This was one of the original reasons for security disclosure in England and in the United States.[133] The disclosure required for this purpose is periodic, ongoing disclosure to enable shareholders to identify breaches of management's duties.[134] This is the type of disclosure required by the CA 1993. The SA 1978 requires one-off disclosure for the issue of shares and little periodic disclosure.[135] The NZSE listing rules require

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[129] Wishart, above n 127, 258.
[130] Mark Blair and Ian M. Ramsay, "Mandatory Corporate Disclosure Rules and Security Regulation" in Gordon Walker and Brent Fisse (eds) *Securities Regulation in Australia and New Zealand*, (Oxford University Press, Auckland, 1994) 265, 269.
[131] Donald C. Langevoort, *Commentary: Stakeholder Values, Disclosure, and Materiality* 48 Cath U L Rev 93, 95 - 96.
[132] Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems* 62 U Chi L Rev 1047, 1048.
[133] Mahoney, above n 132, 1055 – 1077.
[134] Mahoney, above n 132, 1079.
[135] The main periodic disclosure required under the SA 1978 is the financial statements to be included in the issuer's annual report.

extensive ongoing disclosure but this is for the purpose of efficiency[136] not accountability.

2 *Corporate governance*

Corporate governance means "the … mechanisms that shape the structure of incentives, disincentives, and prohibitions under which an issuer's management makes decisions."[137] Mandatory disclosure (under the CA 1993) may help with corporate governance. Disclosure can help large shareholders of an issuer more effectively "exercis[e] their voting franchise."[138] This is because they may be more informed than under a voluntary disclosure regime. It can also help shareholders to "enforce management's fiduciary duties."[139] In this way it can help with the corporate governance of an issuer.

When applied to securities regulation this justification seems to be more of a retrospective justification rather than the reason the legislation was enacted. In my opinion, although the SA 1978 and the listing rules may increase corporate governance, they should not be directed at this purpose since regulation for this purpose is contained in the CA 1993.

3 *Other reasons*

Two of the reasons, which can be used to justify disclosure in the area of company law are dealt with in the next section because they are often used to justify mandatory disclosure in the securities industry. These are deterrence of fraud and protection of investors.

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[136] See quote referred to by note 123.
[137] Merritt B. Fox, *Challenges to Corporate Governance: Required Disclosure and Corporate Governance* 62 Law & Contemp Prob 113 [*Corporate Governance*].
[138] *Corporate Governance*, above n 137, 116.
[139] *Corporate Governance*, above n 137, 118.

II THE DISCLOSURE REQUIREMENTS OF THE SECURITIES ACT 1978 AND THE NEW ZEALAND STOCK EXCHANGE LISTING RULES

In the remainder of this paper 'mandatory disclosure' is used to refer to the regulation of the securities industry contained in the SA 1978 and the NZSE listing rules.

A The Level of Disclosure Without a Mandatory Regime (Voluntary Disclosure)

This section discusses what the level of disclosure without any regulation would be. If disclosure is voluntary it is the management of the issuer not the investors or the government that determine how much to disclose.[140] Therefore a discussion of the level of disclosure without regulation involves an analysis of the costs and benefits of disclosure to the managers.

1 Incentives to disclose information

Market forces drive a public issuer to disclose information to the public.[141] This is proven by the fact that before there were any disclosure requirements issuers would disclose financial statements and other information to the market.[142] There are a number of incentives for the managers of the issuer to disclose information, these are mentioned below.

Because of these incentives the issuer will release information to the market. This may result in improved market efficiency and fairness.[143] If optimal market efficiency and adequate fairness is achieved under a voluntary disclosure regime there may be no need of mandatory disclosure requirements.

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[140] Merritt B. Fox *"Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment"* (1999) 85 Va L R Fox 1336, 1341 [*Retaining Disclosure*].
[141] George J. Benston *Voluntary Vs Mandatory Disclosure* (Report Prepared for the New Zealand Business Round Table 1997) 23.
[142] Benston, above n 141, 13 says, "... financial accounting statements were offered to investors long before they were required by law."

(a) Competition between issuers

An issuer can gain an advantage over competing issuers by disclosing favourable information about their business that can be compared with competing issuers.[144] Disclosure of information is important for an issuer with high value business to distinguish their business from competitors.[145] Non-disclosure of a category of information that competing issuers disclose can lead investors to assume the worst. This could affect the price of the issuer's securities. Thus, competition drives the management of an issuer to disclose information voluntarily.

(b) Monitoring by shareholders

To maintain the price of an issuer's securities the managers of an issuers will want to "produce information (good or bad) which aids in the monitoring of [their] performance by shareholders and others"[146] This is because if shareholders are uncertain about an issuer's performance the issuer's share price will go down. There is an incentive for bad news to be disclosed to stop investors assuming even worse. Thus, issuers have "strong incentives to determine the kind of information ... that investors prefer"[147] and managers of an issuer will disclose information voluntarily to reduce shareholders' monitoring costs. This incentive is discussed further in Part II, II B 4 (c)(ii) of this paper.

(c) The reputation of the issuer

Managers want the issuer to have a reputation that it is competent and can be trusted. If there is insufficient information investors will not be able to evaluate the issuer and this reputation cannot be developed.[148]

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[143] Efficiency and fairness are the two primary justifications for mandatory disclosure.
[144] Benston, above n 141, 15.
[145] Dennis W. Carlton and Jeffery M. Perloff, *Modern Industrial Organization* (2 ed, HarperCollins College Publishers, New York, 1994) 620.
[146] R Dugan and P Gorringe Fairness and Incentives: Economics and Law Reform (Victoria University Press, Wellington, 1990) 60.
[147] Benston, above n 141, 14.

(d) Adverse selection

Generally managers will want to disclose good news to the market since this is likely increase the value of the issuer's securities. According to the adverse selection argument, when one issuer discloses positive information about their product and other issuers disclose nothing, investors will assume that the non-disclosing issuers have an inferior product.[149] This will lead all issuers to disclose information whether good or bad to prevent the signals given off by non-disclosure.

2 Disclosure under a voluntary disclosure system

(a) The role of the law of misrepresentation

Both the disclosure rules and the general law contain a prohibition on fraudulent statements. Requiring an issuer to disclose information is ineffective without this penalty for fraudulent statements.[150] Thus, it may seem that it is only necessary to have a penalty for misrepresentations and leave disclosure to the operation of the market.[151] This may require strengthening New Zealand's misrepresentation law and providing harsher penalties for misrepresentation. Under this view there is no need for the disclosure provisions in the CA 1993 or securities industry. However, this relies on the effective enforcement of the antifraud[152] laws.[153] It is hard to enforce these laws if no disclosure is required. This argument also relies on disclosure being costless to the issuer.

Therefore because of the difficulty with enforcing anti-fraud laws it may be necessary to require disclosure of information. However this disclosure would not need to be more than that required by the CA 1993 which is aimed at deterring fraudulent conduct.

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[148] Benston, above n 141, 16.
[149] Dugan and Gorringe, above n 146, 61.
[150] Christopher J. H. Donald *A Critique of Arguments for Mandatory Continuous Disclosure* 62 Sask L Rev 85, 91 - 92.
[151] This view is put forward in Donald, above n 150, 88 - 93.
[152] Anti-fraud laws refers both to laws dealing with dishonest conduct by issuers and laws dealing with misrepresentations.

(b) A market approach

The justifications for mandatory disclosure assume that the government and the NZSE can produce the correct level of information and that issuers are unable to do this privately. However, it may be possible to leave disclosure to the operation of the market.

Firstly, issuers have incentives to disclose information to investors. The information investors require will vary for different groups of investors and different kinds of investment.[154] It may be hard for government to mandate disclosure in the interests of all investors however issuers have strong incentives to do this. Issuers could disclose information to target specific investors. Overall, this could result in adequate information being provided to all investors.

Secondly, the management of an issuer can bind himself or herself using the constitution of the company. The constitution can require full disclosure of all relevant information and provide for liability if this requirement is breached. It is unlikely that this would result in much more disclosure than is already required under the CA 1993 but it could include disclosure of profit forecasts and other 'soft information.' This would eliminate the duplication of disclosure requirements caused by the SA 1978 and the NZSE listing rules.

Investor confidence in managerial disclosure can be enhanced by outside certification of the accuracy of the disclosure or a sale of securities through an investment bank.[155] If the auditor or the investment bank were reputable this would increase investors confidence in the disclosures of the issuer. The investor could also insure against the possibility of inaccurate disclosure with an independent insurance firm. This would eliminate the risk of loss, resulting from non-disclosure of a category of information or fraud, not detectable comparison with other issuers or by the CA 1993 disclosure requirements.

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[153] Carlton and Perloff, above n 145, 625.
[154] Benston, above n 141, 10 – 11.

Thus voluntary disclosure may be adequate if left to the market.

3 The level of disclosure issuers will choose under a voluntary disclosure regime

Many economists argue that an issuer's personal optimal level of disclosure[156] is the same as the optimal level for the whole economy if there are no externalities.[157] This would mean that in the absence of externalities mandating disclosure would not improve the amount of information released. However Professor Merritt B. Fox argues that the issuer's private optimal level of disclosure (POD) would be a lower level than the socially optimal level of disclosure (SOD) even when not counting externalities.[158] This is because at all levels of disclosure the costs are greater and the benefits are less for a POD than the SOD.[159]

(a) Costs

The issuer has 'interfirm' costs. These costs "arise from the fact that the information provided can put the issuer at a disadvantage relative to its competitors, major suppliers, and major customers."[160] This cost is only imposed on the issuer and not on society as a whole since, according to society's view, the interfirm cost imposed on one firm is balanced by the advantage conferred on the other firms. The private marginal costs of the issuer will exceed the socially marginal cost by the amount of the interfirm costs.

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[155] Frank H. Easterbrook and Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors* 70 Va L R 669, 675.

[156] This is where the marginal cost of disclosing the information is equal to the marginal benefit received.

[157] Benston, above n 141, 15 says, "Product providers can gain by providing investors with the information they require up to the point where the product providers' marginal cost of producing the information is equal to the marginal benefit (including savings from not having to get the information from other sources) obtained by investors. If there were no externalities (third party effects) and no fraud, I believe that all economists would conclude that this is the optimal situation for the economy and for individuals."

[158] *Retaining Disclosure*, above n 140. Benston, above n 141, defines externalities as "information that could be used by all investors." (page xii) This definition of externalities is based on the 'public goods hypothesis' (discussed in Part II, II B 4 (c) of this paper). Fox does not take this externality (a benefit to society but not the issuer) into account when assessing the issuer's private optimal level of disclosure. Therefore his analysis does not count externalities.

[159] See Appendix C for a graph illustrating this.

[160] *Retaining Disclosure*, above n 140, 1345.

A second reason that the issuer's private costs of disclosure are higher than the social costs is that "an issuer's managers are in an agency relationship with its shareholders."[161] Disclosure strengthens the shareholders' monitoring of management through increased effectiveness of shareholder voting and enforcing the managers' fiduciary duties. This is another cost on managers not imposed on society as a whole.

(b) Benefits

The issuer's management will not be able to capture all the benefits of disclosure. Thus, the socially marginal benefit will be greater than the private marginal benefit. The sorts of benefits an issuer cannot capture include a reduction in risk to investors with less than fully diversified portfolios[162] and "reduction in the agency costs of management."[163]

Therefore under a voluntary disclosure regime the private optimal level of disclosure for issuers may be less than the socially optimal level. This is a possible market failure that may be remedied by regulation. A mandatory disclosure regime requiring disclosure at the socially optimal level would correct this. However there are some problems with this argument.

Firstly, it is hard to use regulation to make the disclosure of issuers reach the socially optimal level since this level would vary for different types of issuers and different types of securities and it may be hard to determine accurately what the socially optimal level is.

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[161] *Retaining Disclosure*, above n 140, 1355.

[162] A reduction in risk caused by disclosure making a share value more accurate (closer one side or the other to its actual value) will not benefit an investor with a fully diversified portfolio since this sort of risk is already eliminated by the diversified portfolio. However for the investor with a less than fully diversified portfolio the reduction of the risk will be a gain to them. The issuer's management will not capture this sort of social gain.

[163] *Retaining Disclosure*, above n 140, 1357. Disclosure reduces the cost of shareholders monitoring the management's performance (a transaction cost) and thus restricts the management pursuing their own interests. The issuer's management will not capture this benefit to society as a whole.

Secondly, because a firm is in privity with its investors[164] it will disclose information at the level best suited to them not to itself. Fox's argument is like those concerned with externalities (see Part II, II B 4(c) of this paper for a discussion of the public goods hypothesis which concerns externalities) in that it focuses unilaterally on the issuer's management's state of mind. Regarding this sort of argument Homer Kripe noted that:[165]

> Such an argument … ignores the simple fact that an issuer must supply the information demands of the potential buyers of its securities … and firms desiring an active trading market in their securities must supply information sufficient to attract investor interest and to satisfy the needs of recommending brokers and analysts. The whole academic argument is irrelevant because it deals with information unilaterally produced in some kind of empty state of the world, instead of negotiating securities, where the recipient has some bargaining chips and uses them.

B The Justifications for Mandatory Disclosure

The description in Part I shows that in New Zealand there is a special regulatory regime, imposed on issuers of securities to the public, on top of existing business law. This is the SA 1978 and the NZSE listing rules. This regime involves mandating disclosure and a prohibition on fraudulent statements. In this section I will discuss the justifications for this mandatory disclosure regime.

According to economic ideology the government should only intervene in the operation of a market if there has been some identifiable market failure.[166] Thus, the issue regarding every justification for mandatory disclosure is whether there is a 'market solution' and if not, why should mandatory disclosure be the best method to solve this problem.

There are also non-economic justifications for mandatory disclosure. Analysing these justifications involves identifying the problem to be addressed, analysing

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[164] See Part II, II B 4(c)(ii) of this paper for a discussion of this.

[165] Homer Kripe, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose* (1979) 118, quoted in Blair and Ramsay, above n 130, 273. In this extract Kripe was questioning the relevance of the public goods hypothesis as it applies to securities information. However his criticism also applies to arguments based on the incentives facing the issuer's management.

[166] Donald, above n 150, 87 see quote referred to by note 212.

whether government intervention is required and whether mandatory disclosure is the best solution to the problem.

1 The recipients of disclosure

Disclosure is aimed at a number of parties. The three primary parties are the shareholders of the issuer, the government, and the public.[167] Other parties include stakeholders in the company.[168] Stakeholders include "labo[u]r, consumers, local communities, or the public at large."[169] Other potentially interested parties are shareholders of other firms,[170] other firms in the same industry, and the stock exchange.

Therefore, disclosure can be seen to be in the interests of society as a whole (the public) and in the interests of private investors.[171] The view you have of the intended recipient of disclosure determines the content of the disclosure requirements. The CA 1993 disclosure requirements are primarily for investors and creditors of a company. However, the SA 1978 and the NZSE disclosure requirements, while been directed at investors, are also in the interests of society as a whole. This is because of the crucial role of the share-market in the economy.[172]

2 The security market

Fraudulent disclosure can occur in many markets. In most situations only the basic misrepresentation laws apply. However, mandatory disclosure rules in the security industry are not only concerned with misrepresentations or fraudulent conduct, they are concerned with remedying perceived 'market failures' in the production of information. These market failures are said to affect the allocation of scarce resources because of the security market's crucial role in the economy. Thus, there is greater regulation of disclosure in the security market than in other markets.

[167] Eric A. Chiappinelli, *The Moral Basis of State Corporate Law Disclosure* 49 Cath U L Rev 697, 706.
[168] Langevoort, above n 131, 93.
[169] Langevoort, above n 131, 93.
[170] Easterbrook and Fischel, above n 155, 685.
[171] Chiappinelli, above n 167, 707.
[172] This is discussed in Part II, II B 4(b) of this paper.

The security market is made up of two markets. These are the primary and the secondary market. The primary market is the market for the issuing of shares by issuers. The secondary market is the market involved with the trading of those shares between investors. Both markets are regulated by mandatory disclosure requirements. The primary market is regulated by disclosure requirements at the time of an issue of shares[173] and the secondary market is regulated by continuous disclosure required by an issuer.[174]

The primary reason that the security market is regulated is that there may be 'market failures' in the production of information. Another possible reason the security market is regulated is because of the high level of risk involved. Securities are not a normal product since their value is based on expected future earnings of the issuer. Therefore it is necessary that information concerning the issuer be disclosed. Apart from this risk, the fairness arguments for disclosure in the security industry are no more pressing than in other industries. In many markets there is an asymmetry of information between buyers and sellers and sellers have opportunities to exploit buyers.

3 Two categories of justifications

I have arranged the justifications for mandatory disclosure into two main categories. These are justifications based on efficiency and ones based on fairness. However, there is a lot of overlap between these two categories. Both can be broadly be said to be in the public good. Often things that are efficient are also fair; thus some commentators deal only with efficiency. However, the efficiency justifications do not cover all reasons for intervention based on fairness. Also many arguments that can be justified from an efficiency perspective are primarily concerned with fairness. I discuss these justifications in the section dealing with fairness justifications but I mention the efficiency justification for them as well.

[173] This regulation is mainly contained in the SA 1978.
[174] Both the CA 1993 and the NZSE rules have the effect of regulating the secondary market.

The efficiency arguments identify a specific market failure that needs to be remedied by government intervention; the fairness arguments involve remedying other social problems. One efficiency justification for mandatory disclosure not discussed in this section is Fox's argument discussed in Part II, A 3 of this paper.

4 Efficiency

A lot of security regulation and reform is justified from an economic perspective by accuracy enhancement of security prices.[175] This is based on the economic theories regarding security markets being efficient which are discussed below. Even the courts have embraced these theories.[176]

(a) Informational efficiency

Informational efficiency concerns how accurately and quickly the share price of a listed company reflects new information concerning the company.[177] This has also been called relative efficiency, which has been defined as "a measure of the speed with which new information is reflected in price."[178] The level of informational efficiency differs for different types of information but it is safe to assume that the share-market reflects publicly available information very promptly.[179] In New Zealand it is considered that within a few days of information being released to the

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[175] Edmund W. Kitch *The Theory and Practice of Security Disclosure* 61 Brooklyn L Rev 763, 767 - 768.

[176] The United State's Supreme Court decision of *Basic Inc v Levinson* 108 S CT 978 (1988) applied the 'fraud-on-the-market' theory. This theory allows purchasers of a fraudulent issuer's securities who "do not directly rely on misstatements"(page 989) to have a valid claim for fraud. This theory relies on the theory that the market is efficient and it is presumed that the prices of the securities have impounded the misstatements of the issuer. All the purchaser needs to prove is that they relied on the integrity of the market price. Thus, even the courts rely on the economic theory of efficient markets.

[177] Blair and Ramsay, above n 130, 275.

[178] Ronald J. Gilson and Reinier H. Kraakman *The Mechanisms of Market Efficiency* 70 Va L R 549, 560.

[179] The discussion concerning the speed of informational efficiency divides the share-market's response to information into three categories. 'Weak-form efficiency' is when "the information contained in the past sequence of prices of a security is fully reflected in the current market price of that security," semi-strong form efficiency is when "all publicly available information is fully reflected in a security's current market price," and strong-form efficiency is when "all information, whether public or private, is fully reflected in a security's current market price." (Blair and Ramsay, above n 130, 276) For our purposes it is sufficient that the New Zealand share-market responds to all publicly available information (that is, it is has semi-strong form efficiency). The general academic consensus is that all share-markets are at least efficient in this way. This is because the informational efficiency of share-markets has been backed up by empirical evidence (Gilson and Reinier, above n 178, 551).

market it will be reflected in the price of the issuer's shares so that it will not be any advantage for one investor to know more of the publicly available information than another investor.[180]

(b) Allocative efficiency

Allocative efficiency concerns the efficient allocation of resources. In the context of the share market this means the way "the market allocates resources to their most efficient, or highly valued, uses."[181] Thus, it concerns the allocation of capital in the economy. The amount of public information disclosed in the security market determines the accuracy of security prices and this in turn determines the allocative efficiency of that market. More accurate and greater disclosure will lead to investors being able "to arrive at a more accurate assessment of a company's fundamental value."[182] Thus the share prices of the company will be more accurate. The share prices of a company are said to influence the ability of a company to obtain capital. This is because "the number of shares a company has to sell in order to raise a given amount of capital … depends on the price at which such shares can be sold."[183] Thus the pricing mechanism provides the means for the most efficient firm obtaining capital ahead of other firms.

According to this theory, mandatory disclosure in the secondary market will increase the allocative efficiency in the capital market if an issuer would not disclose adequate information voluntarily.

The economic arguments based on efficiency are concerned with a deficiency in the level of information provided by issuers voluntarily. These arguments are discussed below.

(c) The public goods hypothesis

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[180] Benston, above n 141, 11 – 12.
[181] Blair and Ramsay, above n 130, 275.
[182] Marcel Kahan *Securities Laws and the Social Costs of 'Inaccurate' Stock Prices* 41 Duke L J 977, 985.
[183] Kahan, above n 182, 1005.

(i) Production of information

There may be a market failure in the production of information because information concerning an issuer may have the characteristics of a public good.[184] This is because use of it by one person does not exclude others from using it, and does not deplete the total supply of the information available. When a pure public good is supplied by a private company there is usually an under production of it. An issuer will not capture the full benefit of the information since it is hard to get actual and potential investors to collectively pay for the information. Even though the investors may benefit from information it is difficult for them to enter into a collective agreement to pay for it, because it is easy for any investor to 'free-ride' and receive the information without paying for it. Therefore, the issuer will not produce the optimal amount of information voluntarily and regulation may be necessary to bring the level of information to the socially optimal level.

(ii) Under investment in information research / Under production of information

On the side of the securities analyst[185] a sub-optimal level of information may be produced because there will be "insufficient securities research."[186] The analyst will be undercompensated for securities research because of free riding on information they gather. As a result of undercompensation there will be underinvestment in securities research.[187] This results in information being underprovided.

However this may not justify mandatory disclosure. This is because management has incentives to disclose information. One practical reason for managers to disclose information is to reduce shareholders' monitoring costs. The shareholders'

[184] Blair and Ramsay, above n 130, 272 -273.

[185] This applies to both security analysts and to (actual and potential) investors. John C. Coffee, Jr. (in *Market Failure and the Economic Case for a Mandatory Disclosure System* 70 Va L R 717, 725 – 734) discusses the problem of under and over production of information in terms of the security analyst's research costs. Easterbrook and Fischel (above n 155, 681 – 683) discuss the problem in terms of the investor's under and over production of information. However, which ever way you look at it, the researching party will be undercompensated and there will be an under production of information and there will be a duplication of search costs by interested parties (security analysts or investors).

[186] Coffee, above n 185, 725.

[187] Coffee, above n 185, 727.

monitoring costs are borne by the management since if the shareholders cannot monitor management effectively they will discount managers' compensation.[188] This is an incentive for managers to voluntarily disclose information.

Frank H. Easterbrook and Daniel R. Fischel question whether information is a public good in this way.[189] This is because a "firm is in privity with its investors"[190] and the firm and the investors can thus "strike a mutually beneficial bargain."[191] It is in the interests of the firm to disclose the amount of information that investors want. A firm with good news about itself will seek to make this known to actual and potential investors. The firm will also disclose bad news since if it does not investors may assume the worst.

Thus, there are incentives on the firm and on the managers personally to disclose all the information the investors want to know.

(iii) Third party effects

Easterbrook and Fischel give 'third party effects' as a reason that disclosure may not be optimal.[192] This means, because information has the characteristics of a public good, firms will not disclose some information because other firms (and their investors) who benefit from this disclosure will not be prepared to pay for it, and disclosure by one firm unilaterally may give a competitive advantage to other firms.[193] Thus, mandatory disclosure may be necessary to compensate for this. However, Christopher J. H. Donald suggests mandatory disclosure will not overcome this problem because "the real problem that free riding causes is not that firms will fail to disclose information but that they will fail to produce it in the first instance."[194]

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[188] Donald, above n 150, 99. Donald states that "compensation for managers' services will be discounted to take into consideration the fact that managers also receive non-pecuniary compensation either in the form of increased leisure, because they are shirking their responsibilities, or by causing the firm to incur expenditures that are really for the personal benefit of the managers which the shareholders cannot observe."
[189] Easterbrook and Fischel, above n 155, 682 - 685.
[190] Easterbrook and Fischel, above n 155, 682.
[191] Easterbrook and Fischel, above n 155, 683.
[192] Easterbrook and Fischel, above n 155, 685.
[193] Easterbrook and Fischel, above n 155, 685 - 686.
[194] Donald, above n 150, 111.

Thus, there may be the need of other government interventions such as strengthening intellectual property laws rather than mandating disclosure.

(iv) The social waste hypothesis (Over investment in information research / Over production of information)

The social waste hypothesis applies to the duplication of the search costs for investors (or security analysts) finding information about an issuer. These costs result in a dead-weight loss.[195] This waste would be avoided if the issuer had to prepare information and report it and the one off cost was borne by all the investors. However, firms may provide the information voluntarily because they are in privity with their actual and potential investors.[196] Thus, there is an "incentive for the firm and the investors to co-operate with each other by agreeing to have the firm produce the information and disclose it to the market."[197] The extract by Kripe quoted above[198] makes this point. It is not sufficient to just look at firms own incentives, to disclose information, without considering its relationship with its investors.

(d) Fraud

There are two main arguments for mandatory disclosure based on protection against fraud. Fraud here means both dishonest conduct, for instance a director misappropriating the companies funds, and misrepresentations. Firstly, mandatory disclosure deters fraud, this relates to efficiency and fairness. This is because fraud can result in mis-pricing of securities and thus a misallocation of resources, and also in exploitation of investors. Secondly, mandatory disclosure increases accountability for fraud; this is an agency argument and has been dealt with in the section on company law justifications.

(i) Deterrence

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[195] Blair and Ramsay, above n 130, 269.
[196] Easterbrook and Fischel, above n 155, 683.
[197] Donald, above n 150, 101.
[198] See quote refered to by note 165.

Mandatory disclosure can act as a deterrent against fraud. This is because if a manager's acts have to be disclosed the manager the manager is unlikely to be fraudulent and the disclosure rules provide penalties for misrepresentations. Thus, disclosure can prevent fraud before it happens rather than penalize it afterwards.

The disclosure requirements under the CA 1993 should be sufficient to deter fraud. The extra disclosure required by the SA 1978 and the listing rules should be mainly concerned with the accurate pricing of securities not deterring fraudulent conduct. However I discuss the problem of deterring fraud here since many commentators give it as a reason to increase security disclosure.

This justification for mandatory disclosure seems valid since without disclosure of information it may be hard to prove that the fraud occurred to create liability under the general fraud law. However under a voluntary regime fraudulent conduct that is not disclosed may be detectable by comparing the disclosure of an issuer with the disclosure of competing issuers. The Register of Companies could then investigate the issuer and compel the issuer to disclose information.[199]

(e) Problems with accuracy enhancement

There are a number of problems with accuracy enhancement of share prices as a goal of mandatory disclosure. Firstly, if all material information necessary for accuracy enhancement is disclosed there may be harm to the issuer. This is because information may be confidential since there is a need of secrecy in a competitive environment.[200] Thus mandatory disclosure could be damaging to issuers.

Secondly, disclosure of forward-looking information necessary to create allocative efficiency may result in a risk of liability to the issuer.[201] This is because an investor may sue the issuer on the basis of their disclosure. Because disclosure requirements create additional liability they may reduce the amount of information produced by

[199] See Part I, II G.
[200] Kitch, above n 175, 846 - 857.
[201] Kitch, above n 175, 840.

issuers. This is because issuers may not test their products if they do not know the outcome of the tests but know the outcome will have to be disclosed.[202]

Thirdly, Christopher J. H. Donald argues that informational efficiency may not necessarily improve allocative efficiency.[203] He claims informational efficiency in the secondary market has little effect on allocative efficiency in either the secondary or the primary markets. It will have little effect on the secondary market because the information about the value of the firm will become known in that market eventually even if it is not disclosed.[204] It will have little effect on the primary market because it is irrelevant for initial public offerings and seasoned issuers rarely issue more shares but prefer debt financing.[205] Donald notes "stock prices have little bearing on the ability of a seasoned issuer to raise capital by issuing debt."[206] This point is also emphasised by Lynn A. Stout. Stout questions whether accurate prices affect the allocation of goods within the economy. She notes that it is assumed that share prices influence the allocation of resources.[207] The problems with this that she identifies are that companies "rarely rely on equity issues for funding, and stock prices have little or no influence on other, more commonly used sources of capital."[208] Also a lot of firms never list on the stock exchange.[209] The reason that other sources of capital are not affected by stock prices is that most corporate funding is raised by "internally generated cash,"[210] other capital raised, which is financed by borrowing, is determined by "comparing outstanding debt against the value of a corporation's underlying assets, rather than the market price of its stock."[211]

Both Donald and Stout claim that efficient pricing of securities does not significantly affect the allocation of resources. In my opinion this is a convincing argument. Thus, accurate prices of securities is not a valid justification for mandatory disclosure. However, there are justifications for disclosure based on fairness.

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[202] Carlton and Perloff, above n 145, 623 – 624.
[203] Donald, above n 150, 101.
[204] Donald, above n 150, 102.
[205] Donald, above n 150, 103 - 105.
[206] Donald, above n 150, 107.
[207] Lynn A. Stout *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation* 1988 641.
[208] Stout, above n 207, 643.
[209] Stout, above n 207, 646.
[210] Stout, above n 207, 648.
[211] Stout, above n 207, 650.

5 *Fairness*

Donald claims that "[c]onventional economic theory suggests that to justify any government intervention in the market place, some market failure must be identified."[212] However there are some non-economic justifications for mandatory disclosure. The goal of these justifications is to "lead to a fairer distribution of information in society."[213] The first disclosure Act passed in the United States sought to achieve three main objectives. Firstly, "investor protection," [214] secondly, deterring fraudulent conduct,[215] and thirdly, restoring "investor confidence in the capital markets."[216] Deterring fraud has been dealt with under the efficiency section; this section deals with both investor protection and investor confidence since they are related primarily to fairness.

(a) Protection of investors

Investors are vulnerable to abuse by issuers. This is because there is an asymmetry of information between the issuer and the investors. Mandatory disclosure can prevent exploitation of investors by requiring disclosure and providing for penalties for fraudulent disclosure. This is essentially a fairness reason but there may be a market failure because of the asymmetry of information.

The first question is, what is the type of harm caused by issuers exploiting investors. Firstly, there may be damage to the value of the issuer's securities. The managers of an issuer would gain from misappropriating the issuer's funds for their own use. There could also be less severe damage to the issuer resulting from a conflict of interest between the managers and the shareholders.[217] These sorts of agency problems are dealt with by the disclosure required by the CA 1993.

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[212] Donald, above n 150, 87.
[213] Dugan and Gorringe, above n 146, 56.
[214] Kenneth B. Firtel *Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933* 72 S Cal L Rev 851, 856.
[215] Firtel, above n 214, 856.
[216] Firtel, above n 214, 857.

Secondly, under a voluntary disclose regime it could be argued that the exploiting of investors by management not disclosing information could result in inaccurate share prices and excessive risk to investors. The CA 1993 could still deal with these problems since they are related to the agency relationship between managers and shareholders. Even if protection of investors is a valid goal of regulation of the security industry protection from inaccurate prices or excessive risk can be achieved without mandatory disclosure. Fox argues that share prices are unbiased under the efficient market hypothesis. This means, "share prices, on average, equal the actual value of the shares involved regardless of whether issuers are required to produce substantial or minimal disclosure."[218] Thus an investor is protected, on average, from an unfair price by the markets pricing mechanism. An investor is protected from the risk that their shares are inaccurately priced by diversifying their portfolio.[219]

The market would also solve the informational asymmetries between an issuer and its investors. Roberta Romano notes that "[b]ecause firms need capital and investors need information, firms have powerful incentives to disclose information if they are to compete successfully for funds against alternative investment opportunities."[220] Because of these powerful incentives managers have little scope to exploit investors.

(b) Equality between investors

Disclosure of simple financial statements that can be understood by any investor reduces any advantage that an expert investor has over non-expert investors because any publicly available information would be easily accessible. However this is not a valid reason for mandatory disclosure.

Firstly, financial disclosure should ideally be aimed at sophisticated investor or investment analysts.[221] This is because they can assess real value of the firm and their trading, or advice, will cause this information to be impounded in the share price.

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[217] For instance excessive management remuneration or managers entering into self interested transactions.
[218] *Corporate Governance*, above n 137, 116.
[219] *Corporate Governance*, above n 137, 116.
[220] Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation* 107 Yale L J 2379.
[221] Blair and Ramsay, above n 130, 269.

Less informed investors can free ride on their efforts.[222] Thus, an expert has little real advantage since all publicly released information will be reflected in the share prices.

Secondly, superior knowledge is just a consequence of effort and is not "at the expense"[223] of less informed investors. Mark Blair and Ian Ramsay note that "[a]symmetric ... information between investors may simply reflect the differential costs and benefits that are associated with becoming informed."[224] Also less informed investors can invest in unit trusts or indexed funds if they do not have the time to learn how to understand complex financial disclosures.

(c) Informed decisions by investors

One of the initial justifications for mandatory disclosure in the United States was that it would "enable the small investor to identify and invest in higher quality and lower risk securities."[225] Thus it would increase informed decisions by investors. The Australian Government "supports mandatory disclosure rules on the grounds that such rules ... improve investment decisions by investors."[226] This reason is similar to the two previous ones. It does not take into account the impounding of information into share prices and the incentives facing an issuer to disclose the information that investors want.

(d) Protection of the integrity of the share market

Mandatory disclosure can be justified as a way to protect investor confidence in the share market.[227] If investors fear that they will be taken advantage of they may not want to invest.[228] This argument can be justified by both fairness and efficiency. It is can be justified by fairness since its aim is to restore unsophisticated investors' confidence and encourage them to invest in the share-market. It can be justified by

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222 Easterbrook and Fischel, above n 155, 694.
223 Easterbrook and Fischel, above n 155, 694.
224 Blair and Ramsay, above n 130, 268.
225 Coffee, above n 185, 723.
226 Blair and Ramsay, above n 130, 267.
227 Chiappinelli, above n 167, 699. Chiappinelli states that a primary purpose of federal disclosure is "increased confidence in the secondary capital markets"(page 699).
228 Donald, above n 150, 114.

efficiency because if investors remove their funds from the capital market there will be less capital available and the market will be less efficient.

Easterbrook and Fischel claim that this fear of investors is irrational.[229] This is because there is no reason to expect exploitation from either other investors or the issuer for the reasons discussed above.

The New Zealand Government introduced simple disclosure documents as a way to encourage investors to use the share-market to save for their retirement.[230] These documents may have this effect, however there are two problems with this goal of disclosure. Firstly, Government mandated disclosure might lead investors who had previously not trusted the share-market to believe certain investments are sound because they have had to comply with the disclosure requirements. This belief would be unjustified. Secondly, disclosure should be aimed at sophisticated investors since financial information can be hard to simplify and trading on the basis of simplified information may decrease the accuracy of share prices. Thus, the interests of society as a whole outweigh the benefits caused by encouragement of small investors to invest.

However, the international community needs to have confidence in the New Zealand share market. If New Zealand abolished all its disclosure requirements it may not be able to attract overseas investors or issuers. Therefore, even though this lack of confidence may be irrational, it is a justifiable reason for mandatory disclosure in a small country like New Zealand.

6 *Establishment of a format for disclosure*

Another justification for mandatory disclosure is that it creates a model of how information about a company should be presented. Thus, it creates consistency in the disclosure by different issuers. This is useful for comparisons by investors between different investment products and to make it easier for investors to understand disclosure documents. However, a mandatory model could be made available which

[229] Easterbrook and Fischel, above n 155, 694 - 695.
[230] See note 91.

issuers could adopt partially or fully. This would achieve the same goal. This argument is not a justifiable reason for imposing mandatory disclosure requirements on issuers.

7 *Other reasons for mandatory disclosure*

(a) Insider trading and disclosure

In a company the directors have more information about the company than the shareholders. Thus, any trading by the directors in the issuer's shares can be seen as "trading with an informational advantage."[231] However there are reasons why the directors should own shares in their company. These include to align their interests with the shareholders' interests, and to express their confidence in the company. Some argue that insider trading helps with accuracy enhancement because it releases information to the market. However, disclosure is clearly a better way of achieving this goal.[232] Total disclosure of all material information would cure insider trading but this is not possible. However, disclosure may still be justified as a partial remedy to insider trading because it reduces the opportunity for insider trading. In my opinion this argument does not justify mandatory disclosure. Every firm in the securities industry should not be obliged to disclose information because of the possibility that insiders in some firms might trade on inside information. A better way to prevent insider trading is to have legislation prohibiting it.[233]

(b) Public choice theory

Mandatory disclosure has been explained on the basis of the public choice theory.[234] This view claims that disclosure is simply the result of pressure by various interest groups and not based on the "needs of investors nor considerations of market efficiency or market failure."[235] These interest groups could be composed of lawyers

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[231] Kitch, above n 175, 875.
[232] Kitch, above n 175, 878.
[233] The Securities Amendment Act 1988 creates liability for insider trading (ss 7 and 9).
[234] Easterbrook and Fischel, above n 155, 694.
[235] Blair and Ramsay, above n 130, 274.

and other professionals employed in the securities industry.[236] The firms that have to spend money complying with the disclosure requirements may have difficulty forming counter interest groups because of apathy[237] and problems with collective action. However, as we have seen there are many reasons for mandatory disclosure based on 'public benefit' and so it is unlikely that this regulation is purely motivated by interests groups.

8 *The costs of mandatory disclosure*

(a) Costs to issuers

The management of an issuer may not voluntarily disclose information if the costs of preparing the information are greater than the benefits the issuer receives. Disclosure in this situation would be detrimental to both the issuer and investors (since this expense will be reflected in the issuer's performance). However, mandatory disclosure may impose greater costs to an issuer than the benefit the issuer receives.

The costs of disclosure include fees for the employment of a number of professionals including a lawyer (to coordinate the preparation of reports), an accountant, an auditor, and other experts who may be required to give opinions.[238] Also there are publishing costs including costs for printing, artwork, and design of brochures.

There are also costs of litigation associated with a mandatory disclosure regime and costs on the issuer for having to disclose confidential information. Lastly, there are 'indirect' costs of having to disclose information that is inappropriate to investors.[239] This is because this type of disclosure could result in investors being misled.

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[236] Easterbrook and Fischel, above n 155, 671.
[237] Each firm may only be inconvenienced a small amount so it may not be worth their while campaigning against this regulation.
[238] For instance engineers or architects may give information about the cost of future constructions.
[239] Blair and Ramsay, above n 130, 265.

The government would want to mandate disclose so the costs of disclosure reach the level of societies marginal cost. This would take into account the costs imposed on issuers. However, it is hard to assess costs accurately and weigh them up against benefits. This is especially the case when one broad disclosure regime is imposed on many different types of investment. If the costs are inaccurately assessed mandatory disclosure will not be of benefit to investors, issuers, or the public.

PART III CONCLUSION

There is a complex mandatory disclosure regime in New Zealand for listed issuers issuing securities to the public. The regime consists of two levels, the SA 1978 which imposes disclosure requirements at the time of an initial issue of securities and the NZSE listing rules, which impose disclosure requirements as terms in the contract between a listed issuer and the NZSE. Breach of the disclosure requirements in this mandatory regime can attract harsh civil and criminal penalties.

In New Zealand, the CA 1993 provides a system of mandatory disclosure for companies. These requirements are coupled with penalties imposed on the directors. Any disclosure, whether inside or outside this mandatory disclosure structure, is subject to the misrepresentations laws of New Zealand. This law contains both common law and statutory elements and provides penalties for misrepresentations. The question of whether the company law requirements or the law of misrepresentation need strengthening is a different question from whether New Zealand should have mandatory disclosure in the security industry. This paper does not question the necessity of these two levels of regulation but sets out the justifications for them. The two additional levels of regulation (the requirements in the SA 1978 and the NZSE listing rules), which I have labelled the 'mandatory disclosure regime' cannot be justified for the same reasons as disclosure under the CA 1993 or the law of misrepresentation.

Under a voluntary securities disclosure regime, the management of the issuer could provide guaranties that certain fraudulent conduct would not occur and investors could insure themselves to eliminate the risk of loss caused by fraud. However, this would be costly and mandatory disclosure may be a good way to reduce transaction costs and facilitate efficient voluntary transfers, like the role of having default terms in a contract. If this is the case the regulation should provide voluntary default terms rather than a mandatory disclosure regime.

Efficiency is not a valid reason to justify mandatory disclosure because share prices do not substantially affect the allocation of resources. This is because seasoned

issuers have many sources of capital available to them other than new equity issues, which are not influenced by the share price of the issuer. Also the problems supposedly requiring mandatory disclosure because of efficiency are solved by the action of market forces. These market forces are the strong incentives of issuers to provide the information investors want. Also, under an efficiency analysis, the costs of disclosure might not justify the mandatory regime. If the costs exceeded the benefit to managers the regime would not be efficient.

Problems related to fairness in the securities market do not justify mandatory disclosure. These problems are solved by the action of the market and even if they were not they could be dealt with by the disclosure required under the CA 1993. However, international confidence in New Zealand's share–market is a valid reason for mandatory disclosure. This is because the New Zealand share-market is small, dependent on international investment, and cannot afford to lose its reputation.

Therefore, although none of the reasons for mandatory disclosure are justifiable, New Zealand should not unilaterally abolish its mandatory disclosure regime. What is needed is a clearer understanding of the lack of justification for mandatory disclosure internationally which would result in abolition of mandatory disclosure imposed on issuers of securities globally. Until this happens, issuers of securities in New Zealand and around the world will have to comply with this unnecessary restriction on their freedom to contract.

APPENDIX A

Section 38E of the Securities Act 1978

38E(1) [Form and content] Every investment statement shall --

(a) Be in writing; and

(b) State, in a prominent place, the date as at which the investment statement is prepared; and

(c) If a registered prospectus is required in respect of the securities referred to in the investment statement, state that there is a registered prospectus containing an offer
of
securities to which the investment statement relates; and

(d) Contain all information, statements, and other matters that it is required to contain by regulations.

Securities Regulations 1983 Schedule 3D

MATTERS REQUIRED IN INVESTMENT STATEMENTS

1. Information at front of investment statement
2. Description of securities
3. Names and addresses
4. Activities
5. Moneys payable by subscribers
6. Cooling-off period
7. Types of charges
8. Amount of charges
9. Returns
10. Guarantee of securities

11. Risks
12. Consequences of insolvency
13. Alteration of securities
14. Early termination
15. Right to sell securities
16. Enquiries about securities
17. Complaints about securities
18. Prospectus and financial statements
19. Annual information
20. On request information

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APPENDIX B

Section 39 of the Securities Act 1978

39(1) [Content] Every prospectus and registered prospectus shall –

(a) Be in writing and be dated; and

(b) Specify any documents required by section 41 of this Act to be endorsed on or attached to the prospectus or registered prospectus for the purposes of that section; and

(c) Contain all information, statements, certificates, and other matters that it is required to contain by regulations made under this Act.

Securities Regulations 1983 Schedule 1

MATTERS REQUIRED IN REGISTERED PROSPECTUS FOR EQUITY SECURITIES

General Requirements

1. Main terms of offer
2. Name and address of offeror
3. Details of incorporation of issuer
4. Principal subsidiaries of issuer
5. Directorate and advisers

[5A. Restrictions on director's powers]

6. Substantial equity security holders of issuer
7. Description of activities of issuing group
8. Summary of financial statements
9. Prospects and forecasts
10. Provisions relating to initial flotations

11. Acquisition of business or subsidiary
12. Securities paid up otherwise than in cash
13. Options to subscribe for securities of issuing group
14. Appointment and retirement of directors
15. Directors' interests
16. Promoters' interests
17. Material contracts
18. Pending proceedings
19. Preliminary and issue expenses
20. Restrictions on issuing group
21. Other terms of offer and securities

Requirements in respect of Financial Statements

22. Application
23. Balance sheets
24. Capital and reserves
[25. Minority interests]
26. Deferred taxation
27. Term liabilities
28. Current liabilities
29. Commitments and contingent liabilities
30. Fixed assets
31. Investments
32. Current assets
33. Intangible and other assets
[34. Profit and loss statements]
[35. Contents of profit and loss statement]
[36. Statement of cash flows]
37. Other information
38. Special provisions relating to financial institutions

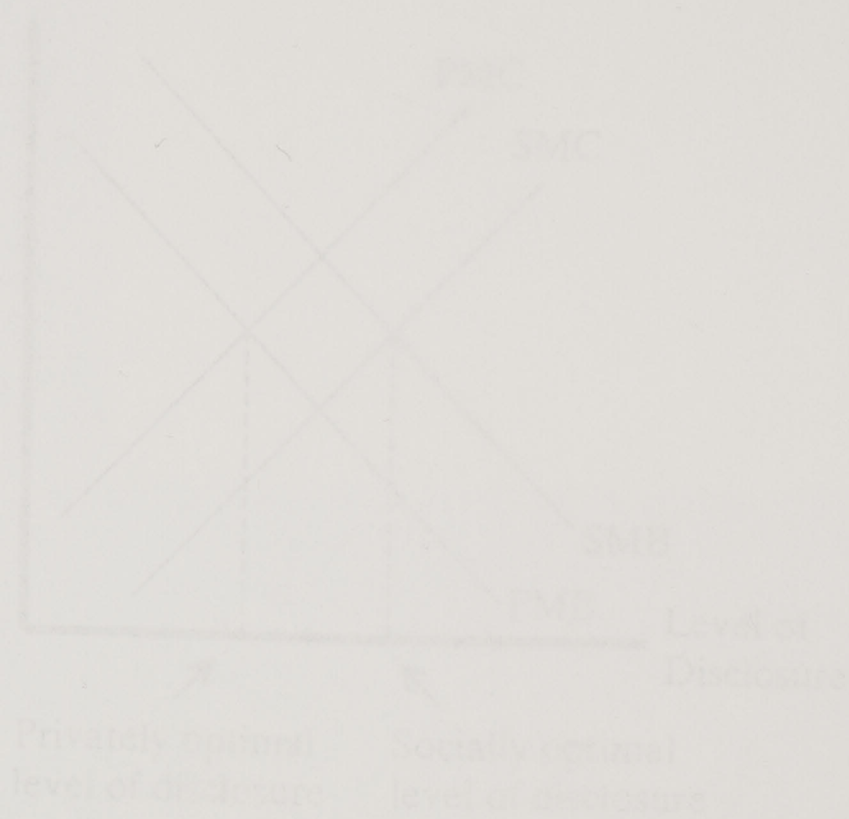
Miscellaneous Requirements

39. Places of inspection of documents

40. Other material matters

41. Directors' statement

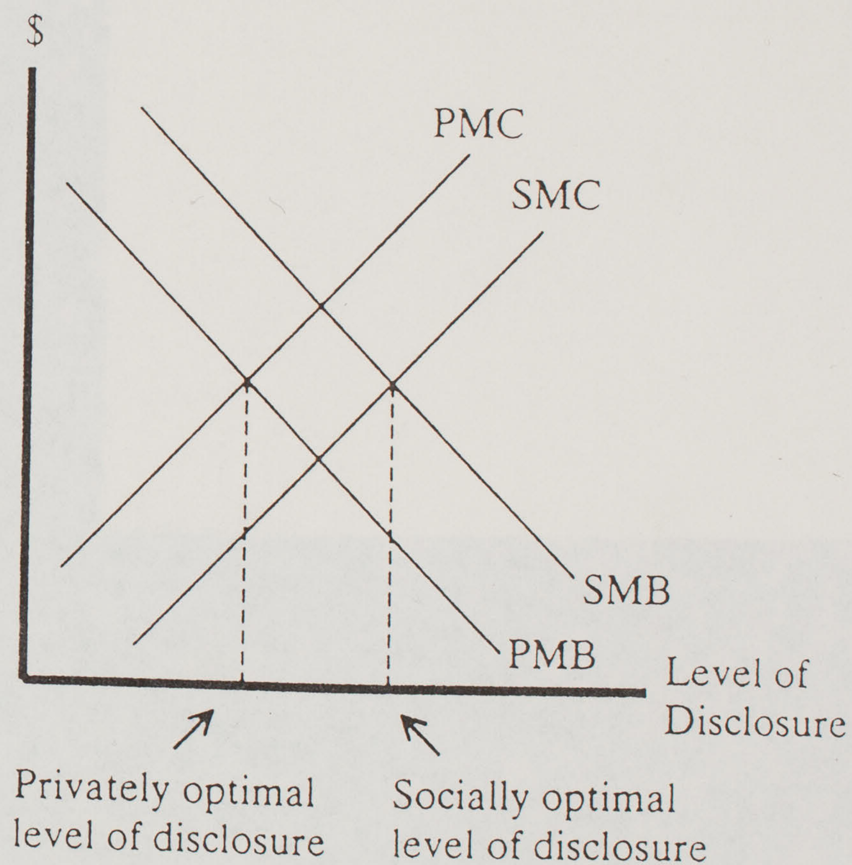
42. Auditor's report



APPENDIX C

This graph illustrates how the issuer's private optimal level of disclosure may be a lower level of disclosure than the socially optimal level of disclosure. It is taken from Professors Fox's article noted at note 140.

PMC is the private marginal cost and SMC is the socially marginal cost.



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